No. 15,096

# In the United States Court of Appeals for the Ninth Circuit

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COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

THE STONECREST CORPORATION and THE BROOKFIELD CORPORATION, RESPONDENTS

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On Appeal from the Decisions of the Tax Court of the United States

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## BRIEF FOR THE PETITIONER

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# INDEX

## CITATIONS

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## OPINION BELOW

The opinion of the court below (R. 120-139) is reported at 24 T. C. 659.

## JURISDICTION

This appeal involves corporation income, declared value excess profits and excess profits taxes of Stonecrest Corporation for the calendar years 1942, 1943 and 1945, in the amount of $254,772.82, plus interest, and of the Brookfield Corporation for the years 1942 through 1945, inclusive, in the amount of $512,-729.23, plus interest, or a combined total tax liability for both corporations of $767,502.05, plus interest, which is made up as follows (R. 120-121, 139-140, 141-142):

STONECREST CORPORATION (R. 120, 139-140)

Deficiencies Assessed

| Year | Income Tax | Excess Profits Tax | Declared Value Excess Profits Tax | Total |
|---|---|---|---|---|
| 1942 | $ 3,766.08 | $29,678.26 | $158,359.56 | $191,803.90 |
| 1943 | [193.16] [1] | 3,883.19 | 42,331.60 | |
| | ------ | ------ | 958.00 [2] | 46,979.63 |
| 1945 | 12,176.55 | 414.62 | 8,115.87 | |
| | [4,717.75] [3] | ------ | ------ | 15,989.29 |
| | | | | $254,772.82 |

BROOKFIELD CORPORATION (R. 121, 141-142)

| Year | Income Tax | Excess Profits Tax | Declared Value Excess Profits Tax | Total |
|---|---|---|---|---|
| 1942 | $ 2,116.32 | 6,514.86 | $ 37,918.40 | $ 46,549.58 |
| 1943 | 21,803.05 | 61,998.28 | 309,345.48 | 393,146.81 |
| 1944 | 1,679.71 | 3,287.51 | 19,278.31 | |
| | 25,507.49 [4] | 972.95 [5] | ------ | 50,725.97 |
| 1945 | 17,686.81 | 1,061.54 | ------ | |
| | 3,558.52 [6] | ------ | ------ | 22,306.87 |
| | | | | $512,729.23 |
| | | Total, both corporations | | $767,502.05 |

[1] Deficiency in income tax for 1943, per Tax Court's decision below. (R. 140.)

[2] Overpayment of excess profits tax for 1943, per Tax Court's decision below. (R. 140.)

[3] Deficiency in income tax for 1945, per Tax Court's decision below. (R. 140.)

[4] Overpayment of income tax for 1944, per Tax Court's decision below. (R. 141.)

[5] Overpayment of declared value excess profits tax for 1944, per Tax Court's decision below. (R. 141.)

[6] Overpayment of income tax for 1945, per Tax Court's decision below. (R. 141.)

On April 9, 1952, the Commissioner mailed to Stonecrest Corporation a notice that there were deficiences in its income, declared value excess profits, and excess profits taxes for the years 1942, 1943 and 1945 in the total amount of $258,725.73. (R. 7, 120). On the same date, he mailed a similar notice to the Brookfield Corporation that there were deficiences in its income, declared value excess profits, and excess profits taxes for the years 1942 through 1945, incusive, in the amount of $482,690,27. (R. 68, 121). Within ninety days thereafter, on July 3, 1952, separate petitions were filed in the Tax Court by the two corporate taxpayers for a redetermination of the respective deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 1, 4). A motion to consolidate the two cases below for hearing and decision was made and granted on September 21, 1953. (R. 2, 4, 31, 121). The decisions of the Tax Court with respect to Stonecrest (R. 139-140) and with respect to Brookfield (R. 141-142) were entered on October 13, 1955 (R. 140, 142). The two cases were brought to this Court by separate petitions for review filed by the Commissioner with respect to Stonecrest (R. 142-144) and with respect to Broookfield (R. 144-146) on January 12, 1956 (R. 144, 146). On April 19, 1956, the parties stipulated that the two cases be consolidated before this Court, on review, for printing, briefing, hearing, argument and decision. (R. 150-151). Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

## QUESTION PRESENTED

Whether on the record facts the Tax Court erred in holding the agreements of sale here not to constitute sales of mortgaged property within the meaning of Section 29.44-2 of Treasury Regulations 111, and in failing to apply the terms of this section in determining the percentage of taxable income to be returned on the installment basis.

## STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

Sec. 44. Installment Basis.

(a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of Realty and Casual Sales of Personality.*—In the case * * * of a sale or other disposition of real property, if * * * the initial payments do not exceed 30 per centum of the selling price * * *, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means the payment received in cash or property other than evidence of indebtedness of the purchaser during the taxable

period in which the sale or other disposition is made.

(26 U.S.C. 1952 ed., Section 44.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939.

Sec. 29.44-2 *Sale of Real Property Involving Deferred Payments.*—* * *

* * * *

In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall be included as a part of the "selling price", but the amount of the mortgage, to the extent it does not exceed the basis to the vendor of the property sold, shall not be considered as a part of the "initial payments" or of the "total contract price", as those terms are used in section 44, in sections 29.44-1 and 29.44-3, and in this section. * * *

## STATEMENT

The pertinent facts giving rise to these petitions for review, as stipulated (R. 19-48, 48-68, 117-119) and as found by the Tax Court below (R. 121-130), appear as follows:

Both Stonecrest Corporation's and Brookfield Corporation's methods of operation were essentially the same. To the extent possible, facts relating only to Stonecrest's operations were treated in the Tax Court's findings. (R. 121.)

During the taxable years, Stonecrest's principal

business was the construction of housing developments consisting of individual residences. Stonecrest (hereinafter referred to as taxpayer) is a California corporation with its principal office in San Francisco. Its income and excess profits tax returns for the years 1942 through 1945 were filed with the Collector in that city. Insofar as the sales here in question are concerned, taxpayer kept its books and records and reported its profits on the installment basis. (R. 121-122.)

Taxpayer's method of operation was as follows: Certain of its shareholders, prior to taxpayer's organization, had participated in a partnership, which purchased an unimproved tract of land, the purchase price being financed partially by partnership funds but principally by a San Francisco bank loan. The loan was evidenced by a promissory note executed by the partners and their wives and secured by a blanket deed of trust covering the entire tract in favor of the lending bank. (R. 122.)

Stonecrest Corporation was formed, with the partners being stockholders, and it purchased the unimproved tract from the partnership. The corporation then submitted its plans for building individual residences to the F.H.A. to obtain the latter's commitment to insure loans on the property. (R. 122.)

Having obtained the general approval of the F.H.A., taxpayer applied to the San Francisco Bank for loans for the construction of individual housing units, which were made after an F.H.A. commitment to insure each loan had been secured. In connection with the loan, taxpayer executed a deed of trust

note and a deed of trust on each unit, which was recorded by the bank. (R. 122.)

The original blanket deed of trust on the entire tract was released on individual lots as loans for the construction of housing units on these lots were made. An agreed release price was paid to the mortgagee bank out of the bank's construction loans. When all of the lots in the subdivisions developed by taxpayer were subject to individual deeds of trust, taxpayer's stockholders and their wives, who had personally signed the original note and blanket deed of trust, were released from their personal liability thereon, so that only the taxpayer was liable to the San Francisco Bank (mortgagee) on the deed of trust notes with respect to houses covered by installment contracts that had not been closed.[7] (R. 122-123.)

When taxpayer negotiated an installment sale to a purchaser, the transaction was carried out in the following manner: The purchaser would execute a "Mortgagor's Statement" contained in a "Mortgagee's Application for Mortgage Insurance," which was filed by the San Francisco Bank (mortgagee) with the F.H.A., together with a "Consent to Substitution of Mortgagors under Title VI." The "Mort-

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[7] In the case of Brookfield Corporation, the shareholders and their wives were required personally to guarantee each individual note secured by individual deeds of trust on the houses constructed and sold, and they were never relieved of their secondary liability on such loans until the loans were either paid in full or, as in a few cases not here in issue, assumed by the purchasers. (R. 123.)

gagor's Statement" contained information regarding the financial status of the mortgagor, *viz.*, purchaser, for the guidance of the F.H.A. in determining whether to insure a mortgage loan on the property being purchased. (R. 123.)

When a house was ready for occupancy, a "Uniform Agreement of Sale" was executed by the purchaser and the taxpayer corporation, and the purchaser also executed that part of the "Consent to Substitution of Mortgagors under Title VI" designated "Purchaser's Certificate," which acknowledged his receipt of the property and contained his agreement to pay the mortgage debt. The purchaser also executed a guarantee to the San Francisco Bank (mortgagee) of taxpayer's obligation on the mortgage loan, and a quitclaim deed to the property in favor of the taxpayer. (Neither the San Francisco Bank nor the F.H.A. retained an executed copy of the Purchaser's Certificate or the purchaser's guarantee of the loan made to taxpayer.) (R. 123-124.)

The Uniform Agreement of Sale provided, in part, as follows (R. 124-126):

> That said Seller [*viz.*, the taxpayer] agrees to sell and convey to the Purchaser, and Purchaser hereby agrees to purchase * * *
>
> [Description of San Francisco property.]
>
> The purchase price for said property * * * is the sum of $4,450.00 payable as follows:
>
> $100.00 in cash, receipt of which is hereby acknowledged;
>
> $47.40 per month * * * for a period of 27 months (first period), and thereafter $33.50 per

month * * * until purchase price and interest are paid in full (second period). Seller heretofore executed a promissory note to The San Francisco Bank [*viz.*, mortgagee] in the principal sum of $4,000.00, and a trust deed conveying said real property to E. T. Kruse and Parker S. Maddux, as trustees, to secure the payment of said note (pursuant to the provisions of Title 6, F.H.A.). Reference is hereby made to the record of said trust deed * * * and the same is hereby incorporated herein. Said installments payable during the first and second periods include interest and charges at the rate and as provided for in said note and trust deed upon that portion of purchase price represented thereby. Installments payable during the first period include interest at the rate of 6% per annum on balance of purchase price. *Said installments shall be applied by the Seller to the requirements of said F.H.A. loan* and to the payment of balance of purchase price and interest thereon. *Monthly installments payable pursuant to said F.H.A. loan are subject to increase or decrease as provided for in said note and trust deed representing the same,* and in the event of such increase or decrease, installments payable hereunder shall be increased or decreased accordingly. Seller shall deliver and Purchaser shall accept conveyance of said property upon first period installments being paid in full at any time thereafter within five years therefrom at option of Seller, and Purchaser shall thereupon assume the performance of Seller's unperformed obligations under the terms of said note and trust deed, and Purchaser hereby consents to Seller being then released therefrom. For

this purpose, Purchaser executes an assumption concurrently herewith, delivers the same to Seller, and the Seller is authorized to deliver said assumption to The San Francisco Bank upon delivery of said Conveyance. Thereafter balance of purchase price shall consist of monthly payments required by said note and trust deed provided in the event Seller cannot secure said release of liability from said note and trust deed. Seller may withhold delivery of conveyance and parties shall function under this Agreement until such release is obtained or Seller may deliver conveyance at any time sooner if Seller so elects. * * *

Purchaser concurrently herewith executes and delivers to Seller a quitclaim deed to said property. Seller may at any time after default by the Purchaser in the performance of the obligations herein provided for, record said quitclaim deed. Said quitclaim deed shall be returned to Purchaser upon Purchaser's becoming entitled to a conveyance hereunder. (Emphasis supplied.)

Other provisions related to taxes on the property, title, and possession. Some of the sales agreements used by taxpayer varied from the form set out above; instead of the requirement that the seller deliver and the buyer accept conveyance of the property within 5 years after the first period installments had been made, the option was given to the buyer to require a conveyance of the property after 8 (in some agreements 12) years from the agreement date. (R. 126.)

Although the agreement called for the concurrent

assumption of the mortgage by the purchaser, to be used when property was conveyed to a purchaser, the document actually signed was the purchaser's guarantee of taxpayer's mortgage loan. *Even if title had passed before complete performance by the purchaser, the taxpayer would have remained primarily liable to the bank for the unpaid amount of the mortgage.*[8] (R. 126-127.)

Taxpayer reported the following number of sales between 1942 and 1945 on the installment basis (R. 127):

| Year | Stonecrest | Brookfield |
|---|---|---|
| 1942 | 349 | 103 |
| 1943 | 88 | 605 |
| 1944 | 9 | ------ |
| 1945 | 91 | ------ |
| | 537 | 708 |

The level of payments that the purchaser was required to make during the first 27 months was greater than the level of payments during the remaining period of the installment contract, the *difference* in level representing the *excess* of *purchase price* (less downpayment) *over* the original amount of the *mortgage loan,* plus interest on the excess. (R. 127.)

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[8] This finding is somewhat difficult to understand inasmuch as the Uniform Agreement of Sale expressly provides that purchaser execute an assumption of the mortgage and consent to taxpayer's release, as mortgagor. Coupled with this provision is the additional one that "in the event Seller cannot secure said release * * * Seller may withhold delivery of conveyance." (R. 126.)

In no single case under the Uniform Agreement of Sale did the taxpayer exercise its option to deed property to a purchaser. In no single case under any agreement of sale did a purchaser exercise an option to receive a deed prior to full payment of the total purchase price. (R. 127.)

All monthly payments on contracts were made directly to the taxpayer by the purchaser, and all monthly payments due on loans were made directly by the taxpayer to The San Francisco Bank (mortgagee) until the property was deeded to the purchaser, at which time the purchaser's contract account was closed and the unrealized profit applicable thereto was reported as income for that year. There was no intended synchronization between the time fixed for payments due from purchasers on homes sold under installment contracts and the time fixed for payments by taxpayer to the mortgagee-bank on its loans secured by deeds of trust on the properties sold on the installment plan. (R. 127-128.)

The mortgagee-bank carried all loans on its books and records as loans due from the taxpayer from the date each individual loan was granted until the closing out of the installment contract pertaining to the property on which taxpayer had executed a deed of trust as security for the loan. (R. 128.)

Every installment sales contract reflected on taxpayer's books was closed by taxpayer at the time the property covered by the contract was deeded to the purchaser. In substantially all cases the property covered by an installment sales contract was not deeded to the purchaser until the purchaser paid

the amount remaining due on the installment sales contract, and, concurrently with the receipt of such sum, taxpayer paid the bank the amount due on the loan which was secured by a deed of trust on the property covered by the installment sales contract.[9] (R. 128.)

The taxpayers reported as income from the sales here in question that proportion of the installment payments actually received which the gross profit to be realized on the sale bore to the total contract price. *"Total contract price" was considered to be the amount for which a property sold, without any deduction for the amount of the mortgage.* (R. 129.)

In determining the percentage of each installment to be returned as income in the taxable years, the Commissioner, applying the rule of Section 29.44-2 of Treasury Regulations 111, included the amount of the mortgage in the "selling price" but excluded

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[9] In a few cases, by special arrangement between the taxpayer and purchaser, the taxpayer deeded property to a purchaser without requiring payment of the purchase price in full. In each of such cases, which in the aggregate represented only a small percentage of the total number of contracts, the deed was issued for individual and personal reasons and not as a matter of right on the part of either party. In such cases the purchaser made arrangements with the bank (mortgagee) to assume the mortgage and paid taxpayer any amount due on the installment sales contract in excess of the amount due on the deed of trust note. Taxpayer, in every such instance, closed such purchaser's installment sales contract and reported unrealized profit on the installment sale as income in that year. None of these transactions involved the exercise of any option given to either party under the Uniform Agreement of Sale (R. 128-129.)

the mortgage from the "total contract price" to the extent that it did not exceed taxpayer's basis in the property. Since in each of the sales made by both taxpayers the mortgage on the individual property *exceeded* the seller's basis, the Commissioner, in determining the deficiencies, added the *excess* to the basis in determining the "total contract price." In computing the "initial payments," the Commissioner included the purchaser's downpayment, payments on the purchase price during the taxable period when the sale was made, and the *excess* of the mortgage over the taxpayer's basis. Using this method, the Commissioner determined that 100% of the installment payments received [retained] by taxpayers during the years in question should be reported as profit for those years, with the exception of Stonecrest's 1945 taxable year, for which the percentage was 83.5. (R. 129-130.)

Before the Tax Court, taxpayers argued (Br. 17-53) that, under the above facts, taxpayers' sales of the mortgaged realty on the installment plan, while qualifying under Section 44(b) of the Internal Revenue Code of 1939, were not subject to the provisions of Section 29.44-2 of Treasury Regulations 111, which had been applied by the Commissioner in determining the deficiencies. Specifically, the taxpayers contended (Br. 17-39), and the Tax Court held (R. 138), that, under the Uniform Agreement of Sale, the purchasers of the homes neither took the realty "subject to" the outstanding mortgage nor assumed such mortgage. Accordingly, the Tax Court held that the Commissioner erred in deducting the

amount of the mortgage (to the extent it did not exceed taxpayers' basis) from the total contract price in determining the percentage of income from installment sales to be returned by taxpayers during the taxable years in question. Judge Tietjens held (R. 139), further, that the Commissioner erred in including the *excess* of the mortgage over the seller's basis in "initial payments."

The Commissioner's computation of Stonecrest's realized profit for 1942, based on stipulated figures (R. 43), appears as follows:

| | |
|---|---|
| *Total to be realized:* | |
| Total sales (including mortgage) | $1,593,426.25 |
| Cost of property sold (taxpayer's basis) | 1,250,977.16 |
| Total profit | $ 342,449.09 |
| *Total contract price:* | |
| Selling price | $1,593,426.25 |
| Less: Amt. of mortgage ($1,396,000) limited to the vendor's basis | 1,250,977.16 |
| Total contract price | $ 342,449.09 |
| *Percentage to be applied to collections received in 1942 on contract price:* | |
| *Total profit to be realized ($342,449.09)* = Total contract price ($342,449.09) | 100% |

In 1942, the following collections were received on the contract price and were computed by the Commissioner to be reportable, at 100%, as income to Stonecrest for that year (R. 43):

| | |
|---|---|
| Mortgages on property sold | $1,396,000.00 |
| Less—Stonecrest's basis | 1,250,977.16 |
| Mortgage in *excess* of cost of property sold | $ 145,022.84 |
| Down payments received on property sold | 104,335.97 |
| Other collections on contract price | 15,187.68 |
| Total realized profit applicable to 1942 | $ 264,546.49 |
| Less—Realized profit reported on return | 28,312.33 |
| Understatement of realized profit | $ 236,234.16 |

The same method was followed by Commissioner in computing "initial payments" for both taxpayers for all of the taxable years in question. (R. 43, 63-65.)

## STATEMENT OF POINTS TO BE URGED

The statement of points to be relied on as the basis for this proceeding is set forth in the printed record. (R. 146-148.) In substance, it is the Commissioner's position that, on this record, the Tax Court erred:

1. In failing to hold that the provisions of Section 29.44-2 of Treasury Regulations 111 here applied to taxpayers' sale of mortgaged realty on the installment basis. (R. 147.)

2. In failing to hold that under the terms of the agreement of sale, the purchasers of the mortgaged realty either assumed the mortgages or took the properties subject to the mortgages, within the meaning of Section 29.44-2 of Treasury Regulations 111. (R. 147.)

3. In failing to hold that Section 29.44-2 of Treasury Regulations 111 applies to all installment sales of mortgaged realty made subject to the mortgage. (R. 147.)

4. In construing Section 29.44-2 of Treasury Regulations 111 as applying only where (a) a purchaser takes realty subject to a mortgage or (b) assumes the mortgage. (R. 146-147.)

5. In holding that under the terms of the agreement of sale, taxpayers' purchasers of the mortgaged realty did not assume the mortgage or take the property subject to the mortgage within the meaning of Section 29.44-2 of Treasury Regulations 111 relating to the determination of the percentage of taxable income to be returned on the installment basis.

6. In holding that the Commissioner erred in subtracting from the total contract price the amount of the mortgage to the extent that it did not exceed taxpayers' basis in the property, for purposes of determining the percentage of income from installment sales to be returned by taxpayers during the taxable years in question, and also erred in including the excess of the mortgage over the basis in initial payments. (R. 147-148.)

7. In failing to uphold the action of the Commissioner in following Section 29.44-2 of Treasury Regulations 111, with the result that the amount of the mortgage, to the extent that it did not exceed taxpayers' cost basis, should be deducted from the selling price to determine the total contract price; and that the excess of the mortgage over basis was includible in determining the initial payment. (R. 148.)

8. In holding that G.C.M. 3048, VII-1 Cum. Bull. VII-1, 60 (1928) is indistinguishable from the instant case. (R. 148.)

9. In failing to uphold the deficiencies, as determined by the Commissioner. (R. 148.)

10. In that its opinion and decisions are contrary to law and the Regulations. (R. 148.)

## SUMMARY OF ARGUMENT

The Tax Court erred, as a matter of law, in refusing to hold that Section 29.44-2 of Treasury Regulations 111 applies to taxpayers' installment sale of excess mortgaged realty, under which: (a) for purposes of determining "total contract price", existing mortgages should properly be treated as deductible from the selling price except to the limited extent that, at the time of sale, they do not exceed a taxpayer's lower cost basis; and (b) for purposes of determining the amount of "initial payments", the excess of the amount of the mortgage over taxpayer's basis should be taken into account in computing the percentage of income from installment sales returnable by the taxpayer as realized during the year of sale, within the meaning of Section 44 of the Internal Revenue Code of 1939.

The statute (Section 44 of the 1939 Code) permits a taxpayer, who elects to do so, to report qualifying sales of realty on an installment basis, returning, as income in a given year, "that proportion of the installment payments actually received * * * which the gross profit realized or to be realized when payment is completed, bears to the *total contract price*." (Emphasis supplied.) Specifically, it provides that such income is to be returned on such installment basis "Under regulations prescribed by

the Commissioner with the approval of the Secretary" and that the "*initial payments*" (emphasis supplied) are to embrace "payments received in cash or property * * * during the taxable period in which the sale * * * is made", other than evidences of indebtedness of the purchaser.

The regulation (Section 29.44-2 of Treasury Regulations 111), which the Commissioner contends is governing, provides that, in applicable cases, "the amount of the mortgage * * * shall be included as a part of the 'selling price', but the amount of the mortgage, to the extent it does not exceed the basis to the vendor of the property sold, shall not be considered as a part of the 'initial payments' or of the 'total contract price', as those terms are used in section 44 * * *." This regulation expressly applies "In the sale of mortgaged property * * * whether the property is *merely* taken *subject to* the mortgage *or* whether the mortgage is *assumed* by the purchaser." (Emphasis supplied.)

The validity of the regulation is not here in question and the sole issue presented is whether, under the Uniform Agreement of Sale employed by taxpayer-mortgagors in their sale of excess mortgaged (F.H.A. financed) residential properties, the Regulation applies. The Tax Court erroneously held that, under the agreement of sale, taxpayers' purchasers neither took subject to the existing mortgages nor assumed them, with the result that the excess of face over basis of the mortgages was excludible from the computation of initial payments. In consequence, taxpayers were permitted to spread the entire amount

of the *excess* over the life of the sales contract, by reporting, as installment income, that proportion of the installment payments actually received which the gross profit to be realized bore to the "total contract price", which, in turn, was considered to be the amount for which a property sold, without deduction for the amount of the mortgage.

**A.**

We contend that, under the uncontroverted facts here before the Court and even within the limited construction accorded Section 29.44-2 of Treasury Regulations 111 by the Tax Court, the regulation clearly applies. The Tax Court erred, as a matter of law, in holding that taxpayers' vendees neither took subject to the existing mortgages nor assumed them.

For purposes of applicability of the regulation, it is of no consequence whether the mortgagor's purchaser is an assuming or a non-assuming vendee. Under even the narrow construction adopted by the Tax Court the Regulation applies whether the purchaser merely takes subject to or assumes the existing excess mortgage. Under the federal tax law, as clearly pointed out by the Supreme Court in *Crane* v. *Commissioner*, 331 U.S. 1, when there is real and substantial benefit resulting to the mortgagor on his sale of mortgaged premises, it is *the realities*, rather than fine technical distinctions as to the personal or nonpersonal liability of the purchaser to the mortgagee, which must properly be viewed as controlling. Here, the realities make it clear that taxpayer-mort-

gagors, under the Uniform Agreement of Sale, were relievd of their necessity of making principal and interest payments in the real and substantial sense that their purchasers agreed to make such payments and they, in turn, agreed to turn them over to the mortgagee. Just as realistically the mortgagee becomes the beneficiary of the mutual promises made by the purchaser (to make the mortgage payments) and by the taxpayer-mortgagors (to turn the mortgage payments over to the mortgagee).

The result was achieved under the Uniform Agreement of Sale by (a) reciting taxpayers' execution of the $4,000 promissory note to the mortgagee bank and the deed of trust securing such indebtedness; (b) reciting the full purchase price of $4,450, thus making the payment of the mortgage indebtedness part of the consideration for the agreement of sale; (c) stating the fact that the prior executed deed of trust was duly recorded; (d) stating that the first period installment payments included 6 percent interest on the unpaid purchase price; (e) expressly providing that taxpayers were to apply the installments to the payment of the mortgage and the interest thereon; (f) providing further that the monthly installments payable were subject to increase or decrease in accordance with any increases or decreases provided for in the promissory note and the the deed of trust; (g) providing that, after completion of the first period installment payments (*viz.*, $47.40 for 27 months), taxpayers had the option to convey to the purchaser, in which event the purchaser was obligated to accept conveyance (and for

this purpose the purchaser was required to execute a formal assumption of taxpayers' mortgage obligation, for delivery to the mortgagee-bank); (h) providing that, after formal conveyance, the remaining payments made by the purchaser, together with interest (*viz.*, $33.50) were to conform to the monthly payments called for in the promissory note and deed of trust; and (i) protecting against default prior to formal conveyance by providing that the purchaser execute a quitclaim deed to taxpayer-mortgagors.

Under these facts, we submit that the practical result of the agreement was that the taxpayers' purchasers, in effect, assumed the existing mortgages and, at the very least, took subject to such mortgages. Since the purchaser could only protect his property from foreclosure by making the mortgage payments, which were expressly conditioned on the taxpayers' obligation to act as the conduit, the mortgagee was for all practical purposes, the beneficiary exactly as it would be had the purchaser formally assumed. At the very least, the realty itself was made security for the mortgage indebtedness, so that the mortgagee's ever present right to foreclose in the event of default, made it clear that the purchaser had taken subject to the prior recorded deed of trust. In either view, the Regulation here applies.

**B.**

The same result follows when the inquiry is directed to whether taxpayers' purchasers took subject to the mortgage or assumed under the long established substantive test applied by the California

courts. Under the substantive real property law of California, in circumstances such as here obtained, it is not necessary to have a formal assumption to assert the mortgagee's right to a deficiency judgment against the purchaser from the mortgagor. The purchaser's personal liability to the mortgagee springs from the well known rule in equity that a creditor is entitled to the benefit of any obligations or securities given by his debtor to one who has become a surety of such debtor for the payment of the debt. Neither is it necessary that there should be formal promise, on the part of the purchaser, to pay the mortgage debt, so long as the purchaser's intention to assume the debt appears from a consideration of the entire instrument. The assumption may be made orally, or by separate instrument, or be implied from the transaction of the parties, or be shown by the circumstances under which the purchase is made, as well as by the language used in the agreement. *Hopkins* v. *Warner*, 109 Cal. 133, 136, 137-138, 41 Pac. 818. When there is no formal assumption but the purchase is made expressly subject to the encumbrance and the amount of the indebtedness thereby secured is included in and forms a part of the consideration of the conveyance, the substantive rule is the same. *White* v. *Schader*, 185 Cal. 606, 611, 198 Pac. 19. Obviously, the provisions of the Agreement of Sale which here was used, as detailed in Point A, *supra*, fully satisfied the California substantive test for an assumption on the part of taxpayers' purchasers.

With respect to the enforceability of the mortga-

gee's substantive right to proceed against the taxpayers' purchasers on their personal liability to pay the mortgage indebtedness, it is true that 1933 and 1935 California moratorium legislation, enacted as an emergency measure and not since repealed, serves to cut off the right to secure a deficiency judgment against taxpayers' purchasers. Section 580 (b) and (d), California Code of Civil Procedure. The statutory bar against enforceability, however, does not alter the fact that the question of whether or not the purchaser assumed is, for purposes of application of the regulation, essentially a question of substantive law. This proposition is underscored when consideration is directed to the fact that the Agreement of Sale was drafted for purposes of establishing the parties' substantive rights for a period of 20-25 years, whereas the temporary emergency moratorium legislation then on the books might be repealed at any time during the duration of the contract. In any event, giving full effect to the legislative abridgement of the mortgagee's right to rely on the purchaser's personal liability for the debt, the purchaser's status remains that of a non-assuming vendee who took subject to the mortgage and the mortgagee's right is preserved to recover on the debt the value of the security, which, in this case, is the residential property which the taxpayers sold. The governing regulation applies equally to property subject to a mortgage as to where the mortgage is assumed.

C.

Finally, we submit that the Tax Court erred in applying too narrow and limited a construction to

Section 29.44-2 of Treasury Regulations 111. Whereas under Points A and B, *supra*, we have demonstrated that the regulation is here clearly applicable—*even within* the narrow confines of the Tax Court's construction—we believe that the plain language of the regulation warrants a broader and more comprehensive construction than it has received below.

Under our view of the regulation, we believe the clause—"whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser"—is only illustrative in the sense that the regulation is designed to apply to all purchases of mortgaged realty. It should make no difference, for federal tax purposes, how the mortgagor's purchaser technically becomes committed on his purchase of the mortgaged premises. For purposes of computing installment income arising on the transaction, the amounts returnable in any given year should be computed by every such *mortgagor* on a consistent basis.

## ARGUMENT

### The Tax Court Erred In Holding the Agreements of Sale Not To Constitute Sales of Mortgaged Property Within the Meaning of Section 29.44-2 of Treasury Regulations 111 and In Failing To Apply the Terms of That Section In Determining the Percentage of Taxable Income To Be Returned On the Installment Basis

This case presents the single question of whether Section 29.44-2 of Treasury Regulations 111, promulgated under Section 44 of the Internal Revenue Code of 1939, applies to taxpayers' sales of F.H.A. financed houses during the taxable years here before the

Court. The Tax Court held that the Regulations did not apply. We contend that, as a matter of law, the Tax Court erred.

Section 44 of the 1939 Code, *supra*, grants permission to a taxpayer, who elects to do so, to report sales of realty on an installment basis. Insofar as is here pertinent, the statute provides:

> SEC. 44. INSTALLMENT BASIS.
>
> (a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment basis may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the *total contract price.*
>
> (b) *Sales of Realty and Casual Sales of Personalty.*—In the case * * * of a sale or other disposition of real property, if * * * the initial payments do not exceed 30 per centum of the *selling price* * * *, the income may, *under regulations prescribed by the Commissioner with the approval of the Secretary*, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "*initial payments*" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made. (Emphasis supplied.)
>
> * * * *
>
> (26 U.S.C. 1952 ed., Sec. 44.)

Under his express statutory authorization to promulgate Regulations, granted in Section 212(d) of the Revenue Act of 1926, c. 27, 44 Stat. 9, which was the substantially equivalent forerunner of Section 44, *supra*, the Commissioner promulgated Article 44 of Treasury Regulations 69, which for present purposes, was substantially the same as Section 29.44-2 of Treasury Regulations 111, *supra*, promulgated under the Internal Revenue Code of 1939. The regulation here in issue provides:

> SEC. 29.44-2. *Sale of Real Property Involving Deferred Payments.*— * * *
>
> * * * *
>
> *In the sale of mortgaged property* the amount of the mortgage, whether the property is *merely* taken *subject to* the mortgage *or* whether the mortgage is *assumed* by the purchaser, shall be included as a part of the "*selling price,*" *but* the amount of the mortgage, *to the extent it does not exceed the basis to the vendor of the property sold*, shall *not* be considered as a part of the "initial payments" or of the "total contract price," as those terms are used in section 44 * * * and in this section. * * * (Emphasis added.)

The taxpayers have not questioned the validity of the regulation. As Article 44 of Treasury Regulations 69, its validity was upheld by the Supreme Court in *Burnet* v. *S. & L. Bldg. Corp.*, 288 U.S. 406, where Mr. Justice McReynolds stated (p. 414):

> Installment sales of real estate encumbered by liens give rise to many complications which Congress could not readily foresee. Accordingly, it entrusted to the Commissioner wide dis-

> cretion in respect of details. And considering the practical requirements of the taxing system, we think the regulations now challenged constitute a fair attempt to effectuate the legislative intent. They are within the broad discretion granted to the Commissioner and violate no definite provision of the statute.

Earlier, the Board of Tax Appeals had consistently treated the regulation as valid and given full effect to its provisions with respect to the computation of the amount of profit realized in the year of transfer on the sale of mortgaged real property. See *Bosshardt* v. *Commissioner*, 4 B.T.A. 1262; *Dalriada Realty Co.* v. *Commissioner*, 5 B.T.A. 905; *Pacheco Creek Orchard Co.* v. *Commissioner*, 12 B.T.A. 1358; *Watson* v. *Commissioner*, 20 B.T.A. 270; *Fifty-three West Seventy-second Street, Inc.* v. *Commissioner*, 23 B.T.A. 164; and *Metropolitan Properties Corp.* v. *Commissioner*, 24 B.T.A. 220. See also *Lucas* v. *Schneider*, 47 F. 2d 1006, where the Sixth Circuit, reversing a lower court decision for the taxpayer, held the regulation (Article 44 of Treasury Regulations 69) was applicable to a sale of mortgaged realty, with the result that inclusion of the assumed mortgage excess in "initial payments" prevented the transaction from qualifying percentage-wise, as an installment sale, within the meaning of Section 212(d) of the Revenue Act of 1926.[10]

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[10] Under Section 212(d) of the 1926 Act, profits on the sale of realty could be computed on the installment sale basis if "initial payments" did not exceed 25% of the purchase price. In the cited case, inclusion of the assumed

Regulations substantially identical to the governing Treasury Regulations 111 (Section 29.44-2) were likewise earlier promulgated as Article 352 of Treasury Regulations 74 (Revenue Act of 1928); Article 352 of Treasury Regulations 77 (Revenue Act of 1932); Article 44-2 of Treasury Regulations 86 (Revenue Act of 1934); Article 44-2 of Treasury Regulations 94 (Revenue Act of 1936); Article 44-2 of Treasury Regulations 101 (Revenue Act of 1938); and Section 19.44-2 of Treasury Regulations 111, the first Regulations promulgated under the Internal Revenue Code of 1939. Subsequent to Section 29.44-2 of Treasury Regulations 111, the identical provision was included in Section 39.44-2(c) of Treasury Regulations 118, also promulgated under the Internal Revenue Code of 1939. Thus the well settled principle is here completely applicable that Treasury Regulations long continued without substantial change, applying to unamended or substantially reenacted statutes are to be viewed as having received legislative approval and to have the force and effect of law. *Boehm* v. *Commissioner*, 326 U.S. 287, 292; *Commissioner* v. *Flowers*, 326 U.S. 465, 469; *Commissioner* v. *Wheeler*, 324 U.S. 542, 547, rehearing denied, 325 U.S. 892; *Helvering* v. *Griffiths*, 318 U.S. 371, 393; and *Sharon Herald Co.* v. *Granger*, 195 F. 2d 890, 894 (C. A. 3d).

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mortgage excess of $37,802.54, coupled with the cash down payment of $13,066.27, served to increase the "initial payment" to an amount in excess of 25% of the purchase price of $155,000, thus disqualifying the transaction for installment sales treatment under the 1926 Revenue Act.

The taxpayers' contention made before the Tax Court was, essentially, that they were entitled to the benefit of reporting income on their sale of houses under the favorable installment option provided in Section 44 of the 1939 Code but were not subject to the computation requirements prescribed by Section 29.44-2 of Treasury Regulations 111. Specifically, they argued that: (a) their purchasers neither *technically* assumed the mortgage nor took the realty "subject to" it, thus making Section 29.44-2 inapplicable to the sales transactions here involved (Opening Br. 17-39; Reply Br. 22-34); (b) the Commissioner's interpretation of Section 29.44-2, if adopted, would render the regulation invalid within the specific provisions of Section 44 of the 1939 Code (Opening Br. 40-53; Reply Br. 1-16, 21-22); and (c) the case of *Crane v. Commissioner*, 331 U.S. 1, to the extent relied on by the Commissioner, is irrelevant to the issues here presented (Opening Br. 53-57; Reply Br. 17-20).

The Tax Court did not deal specifically with taxpayers' contentions (b) and (c), *supra*, but regarded contention (a), *supra*, as controlling with respect to the applicability of Section 29.44-2 of Treasury Regulations 111, saying (R. 133):

> Whether the respondent has properly determined the amount of income received by petitioners turns on whether a buyer from petitioners either assumed the mortgage on the property or took the property subject to the mortgage within the meaning of the regulation.

The Tax Court then applied a very narrow, and we submit erroneous, construction to Section 29.44-2 which depended upon: (a) treating the term "sale of mortgaged property" as embracing *only* the *two* situations referred to in the illustrative clause, "*whether* the property is *merely* taken subject to the mortgage or *whether* the mortgage is *assumed* by the purchaser" (emphasis supplied) (R. 133); and (b) applying an unduly restricted definition of *taking* "*subject to*" a mortgage (R. 133-134) and for *assuming* a mortgage (R. 134). The Tax Court then made reference to certain of the terms of the Uniform Agreement of Sale (R. 124-127) which it deemed controlling (R. 134-135) and concluded that taxpayers' purchasers had neither assumed (R. 135-136) nor taken "subject to" the existing mortgages (R. 136-137) "as those expressions are customarily used" (R. 138). Finally, the Tax Court stated (R. 137-138) that the Commissioner's position here is contrary to that adopted in G. C. M. 3048, VIII-1 Cum. Bull. 60 (1928), issued in January-June 1928, and added (R. 138) that the cases relied on by the Commissioner as authority for applying the regulation "are distinguishable."

As we shall demonstrate, the Tax Court erred as a matter of law in holding that Section 29.44-2 of Treasury Regulations 111 was here inapplicable. Under the Uniform Agreement of Sale, which taxpayers employed to transfer the excess-mortgaged realty, there can be no serious doubt that their purchasers, at the very least, took the property "subject to" the

existing mortgage. Moreover, there is ample authority for reaching the same conclusion under California real property law. In either event, even under the limited construction accorded the regulation by the Tax Court, the decision below should be reversed. However, we believe that the regulation properly warrants a broader and more comprehensive construction than the Tax Court here allowed. As a practical matter, the regulation was promulgated to apply, in determining percentage of taxable income, *inter alia*, to installment sales of excess-mortgaged realty such as are presented in the case at bar, i.e. to cases where the amount of the mortgage exceeds taxpayer's basis.

### A. *The undisputed record facts clearly warrant the application of Section 29.44-2 of Treasury Regulations 111*

Under the undisputed facts of this case, it becomes unrealistic to accept the Tax Court's holding (R. 130-139) that Section 29.44-2 of Treasury Regulations 111 does not here apply.

Taxpayers' operations were directed to the construction of low-cost housing, financed by F.H.A. insured construction loans made by a San Francisco bank under individual notes and deeds of trust. Prior to execution of such notes and trust deeds, plans for the developments were submitted to the F.H.A. incident to securing its commitment to insure the loans, application for the loans was made to the bank, and a blanket deed of trust was executed, which was later released, *pro tanto*, on a completed unit basis, as the individual trust deeds were executed, preparatory to

sale on a house-by-house installment basis to individual purchasers. With respect to release from the blanket deed of trust, taxpayers' principal officers and their wives were released from their primary liability under these earlier executed blanket deeds of trust and taxpayer corporations remained liable on the individual deed of trust notes executed with respect to houses covered by installment sales contracts. (R. 122-123.)

With respect to the sale of the houses to purchasers, taxpayers required the execution by the purchaser of the following documents: (a) a "Mortgagor's Statement" contained in a "Mortgagee's Application for Mortgage Insurance," which was then filed with the F.H.A. by the lending bank, together with a "Consent to Substitution of Mortgagors Under Title VI";[11] (b) a "Uniform Agreement of Sale" between taxpayers and the purchasers; (c) a "Purchaser's Certificate," which acknowledged the purchaser's receipt of the property and contained his agreement to pay the mortgage debt; (d) a guarantee to the mortgagee bank of the purchaser's obligation on the mortgage loan; and (e) a quitclaim deed to the property in favor of taxpayer. (R. 123-124.)

A typical Uniform Agreement of Sale, referred to above, called for the payment of $4,450, payable $100 down, $47.40 per month for 27 months, and $33.50 per

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[11] The "Mortgagor's Statement" contained information regarding the financial status of the mortgagee (*viz.*, purchaser) for the guidance of the F.H.A. in determining whether to insure a mortgage loan on the property being purchased. (R. 123.)

month "until purchase price and interest are paid in full." It recited that the Seller had already executed a promissory note for $4,000 to the San Francisco Bank, and a trust deed to secure payment of the note, incorporating the recorded trust deed by reference. It stated that the designated monthly payments included interest and charges at the rate and as provided in taxpayers' note and trust deed for $4,000, with the interest on the unpaid balance being at the rate of 6%. It stated that the installments were to be applied by taxpayer to the payment of the F.H.A. loan, with such installments being subject to increase or decrease, as provided for in taxpayer's note to the bank and deed of trust. Upon completion of payment of the first period installments (*viz.*, 27 months), the purchaser agreed to accept conveyance of the property at any time within five, eight or twelve years therefrom at taxpayers' option and assume the performance of taxpayers' unfulfilled obligations under the terms of taxpayers' promissory note and covering deed of trust. "For this purpose," the agreement recited, "Purchaser executes an assumption concurrently herewith, delivers the same to Seller, and the Seller is authorized to deliver said assumption to The San Francisco Bank upon delivery of said conveyance. Thereafter balance of purchase price shall consist of monthly payments required by said note and trust deed * * *." Further, the Agreement of Sale provided: "Purchaser concurrently herewith executes and delivers to Seller a quitclaim deed to said property. Seller may at any time after default by the Purchaser in

the performance of the obligations herein provided for, record said quitclaim deed. Said quitclaim deed shall be returned to Purchaser upon Purchaser's becoming entitled to a conveyance hereunder." (R. 124-126.)

In the case of each of the installment sales made by taxpayers, the existing mortgage on the property *exceeded* taxpayers' cost basis therein. (R. 129.)

With respect to the differential in monthly payments to be made by the purchaser during the first 27 months—*viz.*, \$47.40—and thereafter—*viz.*, \$33.50—the difference in level represented the excess of purchase price (less downpayment) over the original amount of the mortgage loan plus interest on the excess. (R. 127.)[12]

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[12] In addition to the above-outlined record facts spelling out taxpayers' legal relationship to the San Francisco Bank (mortgagee) and the contractual obligations undertaken by themselves and their purchasers under the Uniform Agreement of Sale and pursuant to the F.H.A. financing arrangement, the Tax Court found: (1) neither the bank nor the F.H.A. retained an executed copy of the Purchaser's Certificate or the purchaser's guarantee of the loan made to taxpayers (R. 124); (2) although the Agreement of Sale called for the concurrent execution of an assumption of the mortgage by the purchaser, to be used when the property was formally conveyed, the document actually signed was the purchaser's guarantee of taxpayers' mortgage loan (R. 126-127); (3) in no single case, under the Uniform Agreement of Sale, did taxpayers exercise their option to deed property to a purchaser, nor did any purchaser exercise the option to receive a deed prior to full payment of the total contract price (R. 127); (4) all monthly payments on contracts were made directly to taxpayers by the purchaser and all monthly payments on loans were made by taxpayers to the

Under the above facts, it is submitted that the Tax Court's conclusion that taxpayers' vendees neither took the properties subject to the mortgage nor assumed it becomes highly unrealistic. Not only was the property, in every instance, subject to the prior recorded deeds of trust but the purchaser was required, by terms of the agreement, to accept the obligation of paying both mortgage principal and interest. The fact of the existence of the mortgage was expressly stated in the agreement, the fact that the installments were based on principal and interest payments due the mortgagee and would fluctuate in accordance with the terms of the F.H.A. loan was likewise made explicit, and the Seller's obligations to act as a conduit for purposes of turning over these mortgage payments to the San Francisco Bank was made a condition of the agreement. In addition, the purchaser was required to execute a guarantee

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bank until the property was deeded to the purchaser (at which time the purchaser's contract account was closed with unrealized profit being reported as income in that year), there having been no intended synchronization between the time fixed for payments due from purchasers and the time fixed for taxpayers' payments to the bank on their loans (R. 127-128) ; (5) the mortgagee bank carried all loans on its books and records as loans due from taxpayers from the date each individual loan was granted until the closing out of the installment contract pertaining to the property on which taxpayers had executed a deed of trust as security for such loan (R. 128) ; and (6) taxpayers reported as income from the sales that proportion of the installment payments actually received which the gross profit to be realized bore to the "total contract price," which in turn, was considered to be the amount for which a property sold, without deduction for the amount of the mortgage (R. 129).

of the mortgage loan. For practical purposes, the substance of the transaction was that the purchaser, in effect, assumed the mortgage debt, with title, as a security device, being left in the seller. In any event, since title was not formally conveyed, the recitations in the agreement as to sellers' execution of the note and the Bank's recording of the mortgage, coupled with the express provision keying the installment payments to the principal and interest payments on the trust deed made it clear, beyond doubt, that the purchaser was, at the very least, taking the property subject to the mortgage.

Within the narrow construction it accorded Section 29.44-2 of Treasury Regulations 111, the Tax Court concluded (R. 135) that there was no assumption. It stated (R. 134):

> Where a buyer assumes a mortgage on property, he pays the seller for the latter's redemption interest, and *in addition* promises the seller to pay off the mortgage debt. This promise of the buyer can *ordinarily* be enforced by the mortgagee. 5 Tiffany, The Law of Real Property, section 1435, 1436 (3rd ed. 1939); IV American Law of Property, sections 16,125, 16,127, 16.128-16.132 (1952). (Emphasis supplied.)

The Tax Court then reasoned (R. 135-136) that, since formal delivery and acceptance of conveyance of title, at the buyer's option, was not to take place until a specified period after the first-period installment payments had been made, there was no assumption because the mortgagee was not in a position to enforce the buyer's promise at the time the property

was sold. In the premises, we submit, this conclusion is unrealistic.

There is certainly no question that taxpayers' purchasers committed themselves, under the Uniform Agreement of Sale, to pay taxpayers for their redemption interest and, *in addition*, promised *the sellers* that they would pay off the mortgage debt. Express provision was made for such payments in the agreement. Nor does the contractual postponement of formal transfer of title prevent the installment sales transaction from amounting to an assumption within the broad outline of the quoted rule applied by the Tax Court, so long as the mortgagee secures its right to receive the mortgage principal and interest payments, which the purchaser promises the seller he will pay. Here, the mortgagee's right to receive such payments, made by the purchaser, was expressly secured by providing, in the agreement, that (R. 125): (a) the installments would include interest and charges provided for in the note and trust deed, which was incorporated by reference; (b) such installments were to be applied by taxpayers to the payment of the balance of purchase price and interest on the F.H.A. loan; and (c) such monthly installments would be subject to increase or decrease as provided for in said note and trust deed. Under such an arrangement and with taxpayers retaining formal title but securing a quitclaim deed from the purchaser, any additional direct promise to pay, made by the purchaser to the mortgagee, would amount to no more than surplusage. Looking to the realities of the sale and purchase transaction rather

than to the form of selected and isolated features of the transaction, it can clearly be seen that, for all practical purposes, taxpayers' purchasers assumed the underlying mortgages.

Under the same narrow construction of the regulation, the Tax Court concluded (R. 136-137) that the purchasers had not taken the property "subject to" the underlying mortgages. Again relying on 5 Tiffany, Law of Real Property (3d ed., 1939), Sec. 1435, p. 365, the Tax Court stated, *inter alia* (pp. 136-137):

> Here there was no understanding that the debt was to be satisfied out of the property; instead it was explicitly provided in the agreement of the parties that the seller was to make the payments on the mortgage debt until there was a conveyance of the property. * * *
>
> In this case there was no reduction in selling price because of the mortgage and it seems clear that the seller was intended to pay the mortgage debt out of the proceeds of the sale. By his interpretation respondent would extend the application of the regulation to every sale of property that has a mortgage on it. While in a sense every sale of mortgaged property is subject to a mortgage since the property remains liable to have the mortgage debt satisfied from it, we think the expression was used in the regulation in its customary meaning, to define the obligations of the parties to a sale of property with respect to the mortgage debt.

The Tax Court's conclusion that taxpayers' purchasers did not take possession "subject to" the mort-

gage is also unrealistic. Ample warrant can be found in the record and in the decided cases for a contrary holding on this issue. In the first place, the Uniform Agreement of Sale recites (R. 124-125):

> Seller heretofore executed a promissory note to the San Francisco Bank in the principal sum of $4,000.00, and a trust deed conveying said real property to E. T. Kruse and Parker S. Madux, as trustees, to secure the payment of said note (pursuant to the provisions of Title 6, F.H.A.). Reference is hereby made to the record of said trust deed in the office of the Recorder of the City and County of San Francisco, and the same is hereby incorporated herein.

This express incorporation of the mortgage by reference, we submit, clearly indicates on the face of the agreement under which purchaser took possession that he was taking, at the very least, subject to the prior recorded deed of trust. The additional provisions in the agreement relating to the parties' mutually conditioned promises to pay mortgage principal and interest only strengthen this conclusion.

Essentially, the Tax Court's reasoning with respect to this issue is that the purchaser here did not take "subject to" the mortgage because there was no agreement that the debt was to be satisfied out of the property and the purchase price was not reduced by reason of the mortgage. Realistically, neither of these arguments should here be accorded weight. Under the agreement of sale, as between the buyer and the seller, the latter had no obligation to satisfy the mortgage debt, since the buyer's obligation covered

payment in full. With respect to the property itself, there *was* an understanding. By virtue of the executed quitclaim to the seller, which the seller was authorized to record should the purchaser default, the land itself would revert to the taxpayers subject to the mortgagee's rights therein. Finally, see *Pacheco Creek Orchard Co.* v. *Commissioner*, 12 B.T.A. 1358, for the proposition that, for purposes of applying the regulation, whether or not the purchase price is reduced by the amount of the mortgage makes no difference as a factor in determining that a purchaser takes "subject to" the mortgage. In that case, the purchase price was stated in the contract for deed to be $210,808.88, which amount included a mortgage of $73,000. Construing the underlying lease and the contract for deed, the Tax Court applied Article 44 of Regulations 69 and concluded (p. 1364):

> In the instant case, there was no assumption of the mortgage in express terms, *but the property was purchased subject to the mortgage* and the purchaser paid it together with the interest thereon. [Emphasis supplied.]

It is interesting to note that the Tax Court, in its opinion (R. 138), makes no serious effort to distinguish the *Pacheco Creek Orchard Co.* case, *supra*. See also *Metropolitan Properties Corp.* v. *Commissioner*, 24 B.T.A. 220.

As we have demonstrated above, the facts here realistically viewed, furnish ample warrant for holding that, as a practical matter, taxpayers' purchasers either assumed the underlying mortgages pursuant to the transaction of purchase and sale or took the

properties "subject to" the underlying mortgages. In either event, even under the narrow construction accorded Section 29.44-2 of Treasury Regulations 111 by the Tax Court, the regulation is here clearly applicable. The Tax Court's objection that (R. 137) "By his interpretation respondent would extend the application of the regulation to every sale of property that has a mortgage on it" is, at best, misleading. The regulation, by its own terms, is applicable in cases, such as this, involving the sale of mortgaged property where the amount of the mortgage *exceeds* the vendor's basis. Moreover, in the case of such sales, the Supreme Court has adopted the view which we have advanced above, namely, that, for federal tax purposes, in characterizing a mortgage transaction as an assumption or as a taking "subject to", it is the *realties* which should be viewed as controlling. *Crane* v. *Commissioner*, 331 U.S. 1.

In the *Crane* case, the taxpayer inherited an apartment building subject to a mortgage of $255,000 and unpaid interest of $7,000, took depreciation on a value equal to this encumbrance basis for several years, and then sold the property to a third party for $2,500, subject to the $255,000 mortgage. The Court held that, under Section 111(b) of the 1939 Code the amount realized by taxpayer on the sale included the amount of the mortgage and was not to be limited to her equity of $2,500. In this connection, Chief Justice Vinson stated (p. 14):

> * * * we think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consider-

> ation, realizes a benefit in the amount of the mortgage as well as the boot. If a purchaser pays boot, it is immaterial as to our problem whether the mortgagor is also to receive money from the purchaser to discharge the mortgage prior to sale, or whether he is merely to transfer subject to the mortgage—it may make a difference to the purchaser and to the mortgagee, but not to the mortgagor. Or put in another way, we are no more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.

Under such a rationale, we submit, the realities of the instant sales of excess mortgaged property serve to produce identical benefit to the taxpayers, whether the purchaser is viewed as taking "subject to" or as assuming the mortgage—*viz.*, provision is made for payment of the underlying deed of trust, including the amount of the excess over basis.

In the Tax Court below, taxpayers argued against the applicability of the *Crane* case (Opening Br. 53-57) as having no bearing on issues arising under Section 44 of the 1939 Code, dealing with installment

sales. The issue for which we rely on the *Crane* decision, however, is not one of realization versus recognition (*Commissioner* v. *South Texas Co.*, 333 U.S. 496); on the contrary, our reliance on *Crane* is for the broad principle, enunciated, *supra*, that in the presence of substantial benefit to the mortgagor on the sale of mortgaged realty, the realities, rather than fine distinctions should be viewed as controlling, irrespective of whether the purchaser is treated as an assuming or nonassuming grantee. The irrelevance of the distinctions insisted upon by taxpayers and the Tax Court, as well as the general applicability of the principle for which we contend, is underscored when the Court's conclusion, set forth, *supra*, is read with the passage immediately preceding it (331 U.S. 1, 13):

> Petitioner concedes that if she had been personally liable on the mortgage and the purchaser had either paid or assumed it, the amount so paid or assumed would be considered a part of the "amount realized" within the meaning of § 111 (b).[34] The cases so deciding have already repudiated the notion that there must be an actual receipt by the seller himself of "money" or "other property" in their narrowest senses. It was thought to be decisive that one section of the Act must be construed so as not to defeat the intention of another or to frustrate the Act as a whole[35] and that *the taxpayer was the* "bene-

[34] *United States* v. *Hendler,* 303 U.S. 564; *Brons Hotels, Inc.,* 34 B.T.A. 376; *Walter F. Haass,* 37 B.T.A. 948. See *Douglas* v. *Willcuts,* 296 U. S. 1, 8.

[35] See *Brons Hotels, Inc., supra,* 34 B.T.A. at 381.

ficiary" of the payment in "*as real and substantial* [*a sense*] *as of the money had been paid it and then paid over by it to its creditors.*" [36] [Emphasis supplied.]

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[36] See *United States* v. *Hendler, supra,* 303 U. S. at 566.

It is our contention that the realistic benefit resulting to taxpayer-mortgagors on their sale of the mortgaged property by reason of their purchasers' agreement to pay the entire mortgage indebtedness compels the conclusion that, for all practical purposes, taxpayers' purchasers either assumed or, at the least, took the property "subject to" the underlying mortgages. The *Crane* case supports this view and emphasizes the error in the unrealistic and technically narrow interpretation accorded the regulation by the Tax Court below. The broad applicability of the *Crane* rationale also finds support in the Second Circuit's decision in *Commissioner* v. *Fortee Properties*, 211 F. 2d, 915. There the late Judge Frank stated (p. 916):

> While the *Crane* case can literally be distinguished as involving a different section and a different type of transaction, we think both the reasoning and spirit of the opinion are applicable here. * * * satisfaction of a non-assumed mortgage, by payment to the mortgagee, benefits taxpayer in the case at bar. *In practical terms*, for the purpose of protecting his property from foreclosure, where the value of the property is greater than the amount of the mortgage, the taxpayer-mortgagor has to treat

> the obligations of a non-assumed mortgage as if they were his personal obligations. Payment to the mortgagee relieved the owner of this necessity. [Emphasis supplied.]

Similarly here, taxpayers, under their purchasers' commitment to pay the mortgage debt, were relieved of the necessity of making such payments and, under the express terms of the Uniform Agreement of Sale, were made the beneficiaries of such payments in the real and substantial sense that they bound themselves to receive the payments and turn them over to the mortgagee-Bank. *Crane* v. *Commissioner*, 331 U.S. 1, 13. Such benefit is identical to that which will result to a mortgagor, on his sale of mortgaged realty, by reason of his purchaser's payment of the mortgage debt to which he has taken subject or which he has assumed. Accordingly, as a practical matter, the regulation here applies.

Nor is this conclusion less certain when viewed in the light of the findings set out in footnote 12, *supra*. (1) That the "Purchaser's Certificate" came to the Bank's attention, thus confirms the bank's consent to the purchaser's payment of taxpayers' obligation by executing the Uniform Agreement of Sale. Since the obligation was expressly incorporated in the Agreement, there was no practical necessity for either the Bank's or the F.H.A.'s retention of copies of the "Purchaser's Certificate" or the purchaser's guarantee of the loan. (2) Since all of the contracts herebefore the Court involve sales agreements where no conveyance was actually made to the purcaser, it makes no practical difference that the assumptions

agreed to in the sales contract were not actually signed but instead guarantees of taxpayers' mortgage loan. The contractual obligation entered into by the purchaser to execute formal assumptions could undoubtedly have been enforced in equity. Since formal assumptions were not, in fact, used, the distinction here is one without a difference. (3) As indicated in (2), *supra*, since taxpayers did not require any formal assumptions in view of the fact that no options to deliver and receive deeds were exercised, the purchaser's personal liability for the mortgage indebtedness remained, throughout the transaction, an obligation created by contract, both express and implied from all of the instrument's terms as well as from the surrounding circumstances. Accordingly, this finding is academic. (4) The fact that, under the Uniform Agreement of Sale, monthly payments were made directly to taxpayers, with no intended synchronization between the time of the purchaser's making such payments and taxpayers' remitting to the mortgagee, has no real significance. The purchaser's obligation to pay was fixed under the Agreement of Sale; taxpayers' obligation to remit was likwise fixed. The practical reason for channeling the payments through as a conduit, was that the difference between the amount paid to taxpayers and the amount remitted to the bank represented their profit on the transaction. Whether synchronization of the respective parties' payments existed or not, the mortgagee, by reason of taxpayers' notes and trust deeds retained its right to receive payment of the indebtedness. (5) The Bank's method employed in keeping

its accounts with respect to the transaction can in no sense be treated as determinative of the liability of taxpayers' purchasers. Taxpayers, under the Agreement of Sale, were obligated to remit the designated monthly payments called for in the note and deed of trust. The device of using taxpayers as a conduit for channeling the purchasers' payments to the bank made it possible for the bank to account only for the total payments due it, while taxpayers, in turn, accounted for their own profits. As a result, the bank's bookkeeping responsibility was simplified. Moreover, taxpayers' method employed for reporting on the installment basis is in no sense controlling. On the one hand, it is self-serving. In any event, the terms of Section 29.44-2 of Treasury Regulations 111 makes it both incorrect and irrelevant.

Neither are taxpayers justified in placing reliance, as they attempted to do below, on A.R.M. 140, 5 Cum. Bull. 90 (1921) (Reply Br. 24) and on G.C.M. 3048, VII-1 Cum. Bull. 60 (1928) (Opening Br. 36). Actually, A.R.M. 140 was issued in 1918 and dealt with Article 117 of Regulations 33 (revised) promulgated under the Revenue Act of 1917. Under these early Regulations, in determining the amount of initial payments, it was the practice to consider mortgages assumed as the equivalent of cash. The question there before the Commissioner's office for determination was whether or not there had been an assumption under a pre-1926 regulation dissimilar to Section 29.44-2 of Treasury Regulations 111. As for G.C.M. 3048, *supra*, the facts upon which it was predicated are clearly distinguishable from the facts

of the instant case. The ruling concerned a so-called "reducing mortgage" under which the vendor, retaining title until the property was paid for, could at any time encumber it by mortgage to the extent of the amount then remaining due under the contract. In view of the uniqueness of the arrangement, the General Counsel was of the opinion that as of the year of sale it was impossible definitely to determine either that the property would ever be taken subject to a mortgage or that the mortgage ever would be assumed by the purchaser.

Finally, it may be observed that the taxpayers made an equitable argument to the Tax Court (Opening Br. 18) based on the fact that the Commissioner's application of Section 29.44-2 of Treasury Regulations 111 results in taxing the entire profit on these contracts within approximately the first twenty-seven months. They supplemented this contention by arguing at length (Opening Br. 25-32) that application of the regulation would here by incompatible with the statutory requirement, under Section 44, that the requisite proportional amounts of installment payments should be returned over the period of the contract as actually received. The contention was that the entire amount of the profit would eventually be returned over the period of the contract life, and that there was no necessity for application of the regulation to include the excess of the amount of the mortgage basis in initial payments in the year of sale.

The short answer to this argument against taxing the major part of the profit during the first twenty-seven months of the contract is that taxpayers

themselves arranged the transaction so that their profit would be received during the so-called twenty-seven months' first period, during which time the installments amounted to $47.40, as contrasted to subsequent monthly installments over the contract life of only $33.50, which approximated the amount due the mortgagee as principal and interest. (R. 124, 127.) Moreover, it is not the taxation of the first-period profit increment which is placed in issue by application of the regulation; under Section 29.44-2, it is the inclusion of the mortgage excess in "initial payments," for computation purposes, which is in issue. With respect to taxpayers' contention that there is here no necessity for application of the regulation (Opening Br. 31), it is sufficient to observe that the unusual circumstance which calls for the application of the regulation in the case of a sale of mortgaged realty is the fact that the mortgage is *excessive* in that the amount advanced by the mortgagee exceeds the taxpayers' basis in the property. A taxpayer is not required to use the installment basis; it is his voluntary election. Whenever a taxpayer elects to report his sales of excessively mortgaged realty to assuming and/or nonassuming purchasers on the installment basis, as was here the case, the regulation is clearly applicable. In upholding the validity of the regulation in *Burnet* v. *S. & L. Bldg. Corp.*, *supra*, the Supreme Court pointed this out, stating (288 U.S. 406, 414-415):

> The Commissioner's treatment of *the excess* of the mortgages on the 83rd Street property over the base cost followed the general purpose

to place reasonable limitation upon the spread of the tax. It was appropriate *in the unusual circumstances presented*—certainly not prohibited. It was a practical way to accomplish the end. Some possible departure from the method prescribed for ordinary circumstances is not enough to destroy what he deemed necessary to meet unusual conditions.

The excess of $77,967 under the sale agreement would never actually come into the vendor's hands, but it represented part of the admitted profits and was subject to taxation. No positive provision in the statute required that it be spread over subsequent years, and we think there was nothing illegal or oppressive in treating this as if an actual payment. *The taxpayer has been treated more leniently than if required to report upon the accrual basis.* The Regulations were not contrary to any positive provisions of the statute and, as said by the Board of Tax Appeals, were "both equitably and legally sound." [Emphasis supplied.]

**B. *Under California law, the undisputed record facts clearly warrant a holding that taxpayers' purchasers either took the properties "subject to" or assumed the existing mortgages, within the meaning of Section 29.44-2 of Treasury Regulations 111***

We have developed in Part A, *supra*, our contention that, as a matter of federal tax law, the Tax Court erred in holding under the facts obtaining, that Section 29.44-2 of Treasury Regulations 111 is not here applicable. The practical realities of these transactions bring them within the ambit of the Regulations.

Further, however, as an independent ground for reversing the Tax Court's decision below, we submit that, under California law, the conclusion is also warranted that taxpayers' purchasers either assumed the underlying mortgages or, at the least, took subject to them. In this connection, it is interesting to observe that, whereas the Tax Court viewed the applicability of the regulation (R. 133) as turning technically on "whether a buyer * * * either assumed * * * or took * * * subject to the mortgage" "and taxpayer relied heavily below (Opening Br. 43-45; Reply Br. 3-4, 15-17, 28-29) on the Sixth Circuit's decision in *Lucas* v. *Schneider, supra* (where the basis for construing an assumption turned on a purchaser's personal liability to the mortgagee under Kentucky law), no attempt was made by either the taxpayers, on brief, or by the Tax Court, in its opinion, to determine the purchasers' technical status as assuming or nonassuming vendees under the law of California. Instead, taxpayers based their technical argument on Osborne's Handbook on the Law of Mortgages (1951) (Opening Br. 22); Paton's Advanced Accounting (1941) (Opening Br. 37); and 5 Tiffany, Law of Real Property (3d ed.), which was cited by the Tax Court (R. 134, 137) along with IV American Law of Property (1952) (R. 134), as authority for the technical determinations made below—*viz.*, that taxpayers' purchasers neither assumed the excess mortgages nor took subject to them. Since the real property mortgage transaction here under review was effected in California,

we believe an examination of the law of that state will, at least, serve to emphasize the error in the Tax Court's decision.

For purposes of applicability of the regulation, it is necessary, under the Tax Court's view, that the taxpayers' purchaser either take subject to the existing mortgage or assume. Under state real property law, in contradistinction to the adjective aspects of enforceability, this is, of course, a question of substantive law. In California, the substantive issue of whether a purchaser of mortgaged realty takes subject to the mortgage (*viz.*, incurring personal liability to the mortgagee) has frequently arisen in cases where the mortgagee is seeking to obtain a deficiency judgment against the mortgagor's grantee. In a particular case, absent any formal language expressly providing for assumption, the question has been regarded by the California courts as one of intent—*viz.*, a question of fact. *Hopkins* v. *Warner*, 109 Cal. 133, 41 Pac. 818; *White* v. *Schader*, 185 Cal. 606, 198 Pac. 19 (1921); *Hibernia Sav. & Loan Soc.* v. *Dickinson*, 167 Cal. 616, 621, 140 Pac. 265; *Andre* v. *Stilson*, 37 Cal. App. 2d 334, 338-339, 99 P. 2d 557 (1940); *Banta* v. *Rosasco*, 12 Cal. App. 2d 420, 422, 55 P. 2d 601. The California Supreme Court stated the rule in *Hopkins* v. *Warner*, *supra*, as follows (pp. 136, 137-138):

> The right of the plaintiffs [*viz.*, mortagees] to maintain this action [*viz.*, to secure a deficiency judgment] against the appellants [*viz.*, the purchasers of the mortgaged premises] springs from the well-known rule in equity that a

> creditor is entitled to the benefit of any obligations or securities given by his debtor to one who has become a surety of such debtor for the payment of the debt (Sheldon on Subrogation, sec. 85; Jones on Mortgages, sec. 755; Pomeroy's Equity Jurisprudence, sec. 1206; *Keller* v. *Ashford,* 133 U.S. 622; *Crowell* v. *Currier*, 27 N.J. Eq. 154; *William's* v. *Naftzger*, 103 Cal. 438). * * * It is not necessary that there should be a formal promise, on the part of the grantee, to pay the mortgage debt, in order to render him liable therefor, if his intention to assume the debt appears from a consideration of the entire instrument. The obligation may be made orally or in a separate instrument; it may be implied from the transaction of the parties, or it may be shown by the circumstances under which the purchase was made, as well as by the language used in the agreement. (Jones on Mortgages, sec. 748; *Canfield* v. *Shear*, 49 Mich. 313; *Heid* v. *Vreeland,* 30 N.J. Eq. 591).

Again, in *White* v. *Schader*, *supra*, the California Supreme Court stated (p. 611):

> * * * it is well-settled that where the payment of a mortgage forms part of the consideration of a conveyance that the grantee is bound to pay the same. The rule is thus stated in *Brosseau* v. *Lowy*, 209 Ill. 405 [70 N.E. 901]" "It is well established that when a party purchases premises which are encumbered, to secure the payment of indebtedness, and assumes the payment of the indebtedness as a part of the purchase money, the premises purchased are in his hands a primary fund for the payment of the debt, and it is his duty to pay it. (*Lilly* v.

> *Palmer*, 51 Ill. 331; *Russell* v. *Pistor*, 3 Seld. (7 N.Y.) 171.) And the rule is the same, although there be no assumption of payment of the indebtedness, if the purchase be made expressly subject to the incumbrance, and the amount of the indebtedness thereby secured is included in and forms a part of the consideration of the conveyance. (*Lilly* v. *Palmer*, *supra; Comstock* v. *Hitt*, 37 Ill. 542; *Fowler* v. *Fay*, 62 Ill. 375; *Russell* v. *Pistor*, *supra; Ferris* v. *Crawford*, 2 Denio, 598.)" (See also *Tichenor* v. *Dodd*, 4 N.J. Eq. 454.)

Under the rationale of these California decisions, it appears clear that taxpayers' purchasers, under the Uniform Agreement of Sale, assumed the payment of the mortgage indebtedness, owing from taxpayers to the bank. The agreement expressly recited taxpayers' execution of the $4,000 promissory note to the San Francisco Bank and the deed of trust securing such indebtedness. It stated, as the purchase price, the full amount of $4,450, thus making the payment of the mortgage indebtedness part of the consideration for the agreement of sale. The fact that the prior deed of trust was recorded was also expressly stated; as was the fact that the first series of installment payments included interest at 6% on the unpaid balance of the purchase price. In addition, the agreement expressly provided that taxpayers were to apply the installments to the requirements of the loan and to the payment of the purchase price and the interest thereon. It provided further that monthly installments payable were subject to increase or decrease in accordance with any increases

or decreases provided for in the promissory note and the deed of trust. Finally, it provided that, after completion of the first period installment payments, taxpayers had an option to convey to their purchasers, in which event the purchaser was obligated to accept conveyance, and, for such purpose, the purchaser was required to execute an assumption of taxpayers' mortgage obligation, for delivery to the bank. After conveyance, the remaining payments made by the purchaser (together with interest) were to conform to the monthly payments called for in the promissory note and deed of trust. To protect against default prior to conveyance, the purchasers were required to execute quitclaim deeds to taxpayers. (R. 124-126).

Viewing the express provisions of the Uniform Agreement of Sale, *supra*, as a whole, it is compellingly clear that the intent of the parties thereto was that taxpayers' purchasers, upon the execution of the agreement, were obligating themselves to pay the outstanding mortgage indebtedness owing to the bank by reason of taxpayers' prior execution of the recited $4,000 promissory note and covering deed of trust.

First, as a matter of formal promises, the purchaser was under contractual obligation to pay taxpayers installment payments "during the first [*viz.*, $47.40] and second [*viz.*, $33.50] periods" which expressly included "interest and charges at the rate and as provided for in said note and trust deed upon that portion of purchase price represented thereby [*viz.*, $4,000]" (emphasis supplied); tax-

payers, in return, were obligated to apply "Said installments * * * to the requirements of said F.H.A. loan and to the payment of the balance of purchase price and interest thereon" (emphasis supplied). (R. 125). Under the established substantive rule of *Hopkins* v. *Warner*, *supra*, this, in California, amounted to an assumption by formal promise, not even calling for resort to oral expressions of intent, implication, or consideration of the surrounding circumstances since the mortgage debt (*viz.*, $4,000) was expressly made a part of the consideration for the sale. See also *Banta* v. *Rosasco*, 12 Cal. App. 2d 420, 422-423, 55 P. 2d 601, which cites the *Hopkins* v. *Warner* rule, with approval.

Second, even were the parties' intent to have the purchaser assume not thus expressly spelled out, the identical intent is unmistakenly apparent from a consideration of the entire instrument. Thus, the keying of the first period installment payments to the interest and charges provided in the note and trust deed, the requirement that they be applied against the requirements of the F.H.A. loan (which underpinned taxpayers' mortgages), the purchaser's contractual obligation to execute an assumption, the keying of intallment payments to fluctuations in the amount of payments called for in the promissory note and trust deed, the provision that post-conveyance installments conform to the requirements of the note and trust deed, and the execution by the purchaser of a quitclaim (to be recorded in the event of a default) all combine to evidence an intent, clear beyond doubt, that the purchaser, upon execution of

the agreement, became obligated to pay the mortgage indebtedness. Prior to formal conveyance, the mortgagee's right against the purchaser "springs from the well known rule in equity that a creditor is entitled to the benefit of any obligation or securities given by his debtor to one who has become a surety of such debtor for the payment of the debt." *Hopkins v. Warner*, 109 Cal. 133, 136, 41 Pac. 868. Accordingly, upon default, the bank could have the quitclaim recorded, foreclose and sell the land, and under the long established California substantive rule, would have the right to secure a deficiency judgment against the purchaser.

Third, as additional evidence of the intent, which pervades this entire transaction, that taxpayers' purchasers assumed the mortgage indebtedness, we have the buttressing surrounding circumstances. Here, it becomes pertinent that simultaneously with the execution of the Uniform Agreement of Sale the purchaser executed as part of a "Mortgagor's Statement," a "Purchaser's Certificate," acknowledging receipt of the property and the purchaser's agreement to pay the mortgage debt. The significance here is that the "Mortgagor's Statement," and the included "Purchaser's Certificate," were executed for the mortgagee bank, which filed the same with the F.H.A., together with the "Consent to Substitution of Mortgagors Under Title VI." Accordingly, the mortgagee bank, being apprised of the purchase transaction and the purchaser's financial status, for all practical purposes consented to the purchase trans-

action when it filed the "Mortgagee's Application For Mortgage Insurance" with the F.H.A. That the parties' intent was to effect an assumption of the mortgage indebtedness by the purchaser is evidenced by the bank's applying for the loan insurance on the basis of the purchaser's statements concerning his financial responsibility, as well as by its filing the "Consent to Substitution of Mortgagors Under Title VI," and, more particularly, by the express agreement extracted from the purchaser in the Uniform Agreement of Sale, whereby he agreed to execute an assumption for delivery to the bank upon delivery of a conveyance. For purposes of California substantive law, it can thus be seen that the rule for assumption is again satisfied since "The obligation may be made * * * in a separate instrument; it may be implied from the transaction of the parties, or it may be shown by the circumstances under which the purchase was made as well as by the language used in the instrument." *Hopkins* v. *Warner*, *supra; Hibernia Sav. & Loan Soc.* v. *Dickinson*, 167 Cal. 616, 621, 140 Pac. 265; *Andre* v. *Stilson*, 37 Cal. App. 2d 334, 339, 99 P. 2d 557.

From the foregoing it can be clearly seen that the Tax Court erred in holding (R. 135):

> The * * * provisions of the agreement make it clear that there was no assumption of the mortgage when a property was sold by petitioners.

As has been pointed out above, under California substantive law, it is not necessary to have a formally executed assumption to create a right in the mort-

gagee to proceed against the purchaser from the mortgagee on his personal liability for payment of the mortgage indebtedness. Here, prior to conveyance (at which time a formally executed assumption was, by terms of the contract, to become operative) the purchaser was personally liable for the indebtedness under the long established equitable principle that the creditor bank could avail itself of its debtor's contractual rights, *qua* surety, against such purchaser.

The California substantive rule, developed in the cases cited above, makes it clear that, under state law, for purposes of the applicability of Section 29.44-2 of Treasury Regulations 111, taxpayers' purchasers here assumed the existing mortgages. This follows from the fact that the question of whether they assumed or took subject to the mortgage is essentially a question of substantive law. However, with respect to the *enforceability* of the mortgagee's right, in California, to proceed against such purchasers on their personal liability, it must be observed that emergency moratorium legislation, initially enacted in California in 1933 and never repealed, cuts off the mortgagee's right to secure such a deficiency judgment. See Section 580(b) and (d) California Code of Civil Procedure, Stats. 1st Ex. Sess., 1940, ch. 29, § 2; *Mortgage Guarantee Co.* v. *Sampsell*, 51 Cal. App. 2d 180, 185, 124 Pac. 2d 353. Since this legislation was introduced as a temporary emergency measure (*Bank of America, Nat. T. & S. Ass'n* v. *United States*, 84 F. Supp. 387 (S.D. Cal.)),

it can readily be seen that while it suspends the mortgagee's right to deficiency judgment against the assuming grantee, an installment sale contract contemplating 20-25 years for completion of performance must anticipate that Sections 580(b) and (d) *supra*, are not necessarily of indefinite duration.

In any event the protection thus afforded the purchaser from personal liability, as an assuming grantee, will not affect the liability of the property, in other words transform his liability to that of a non-assuming grantee, who takes subject to the existing mortgage. Thus it has been held that Sections 580 and 726 of the California Code of Civil Procedure indicate a legislative intent to limit the mortgagee's right to recover on the debt to no more than the value of the security, which, in this case, is the residential property which the taxpayers sold. *Freedland* v. *Greco*, 45 Cal. 2d 462, 289 P. 2d 463; *Brown* v. *Jensen*, 41 Cal. 2d 193, 259 P. 2d 425. Accordingly, in the event of a default, the quitclaim deeds executed by the purchasers, could be recorded incident to foreclosure on the realty as security for the debt to which the property is subject in the hands of the taxpayers' purchasers, as non-assuming grantees who took subject to the mortgage. See also *Kerrigan* v. *Maloof*, 98 Cal. App. 2d 605, 616, 221 P. 2d 153 (1950), where the court stated that "the natural and normal construction of section 580(b) is that it only applies to contracts of sale where credit is involved."

For the reasons given above we submit, under California law, the conclusion is independently warranted that taxpayers' purchasers, as a matter of

substantive real property law, assumed the existing mortgages under the Uniform Agreement of Sale and the surrounding circumstances. At the very least, giving full effect to Sections 580(b) and (d) of the California Code of Civil Procedure, which were operative when the sales arguments were executed, they took the properties subject to the existing mortgages. Accordingly, the Tax Court's determination to the contrary constitutes reversible error as a matter of law.

### C. *The Tax Court erred in its construction accorded Section 29.44-2 of Treasury Regulations 111*

We submit that the Tax Court further erred in construction of Section 29.44-2 of Treasury Regulations 111, by limiting its application to sales of excess mortgaged property where the mortgagor's purchaser either technically assumes or takes subject to the mortgage. In Parts A and B, *supra*, we have shown that, in any event, the sale and purchase transaction satisfied all of the legal requirements necessary for applicability of the regulation. However, we believe that the plain language of the regulation warrants a broader and more comprehensive construction than it has received in the lower court.

Ascribing to the plain language of the regulation its ordinary meaning, we believe that Section 29.44-2 should properly be viewed as applying to every sale of *excess* mortgaged realty since the obvious purpose of the regulation is to include the *excess*—*viz.*, the amount of the mortgage over and above the amount of the cost basis—in "initial payments," in order to

take such *excess* into account in the year of sale and to include such *excess* in the "total contract price" in determining the percentage of income from installments to be reported over the remaining life of the contract. The result is achieved by including the entire amount of the mortgage in the "selling price" and excluding the amount of the mortgage, to the extent it does not exceed the vendor's basis, from "initial payments" and the "total contract price."

Since the purpose of the regulation is designed to properly compute the mortgagor's returnable income and it was the mortgagor who received the excess it realistically should make no difference, for federal tax purposes, how the mortgagor's purchaser technically becomes committed on his purchase of the mortgaged premises. The only relevant consideration, for purposes of computation of the *mortgagor's* returnable income on the installment sale, is the fact that *it has sold excess mortgaged realty.* That the purchaser's commitment with respect to the mortgagee is not here relevant is made clear in the language of the regulation which treats generally with "the sale of mortgaged property," adding, by way of illustration rather than transaction, "whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser." The regulation's purpose would be served if the illustrative clause were not included at all; on the other hand it contravenes that purpose to restrict the regulation's application to only those situations where the purchaser can technically be viewed as having taken "subject to" the mortgage or as having

"assumed." Accordingly, we submit that the Tax Court erred in its interpretation accorded the regulation below.

## CONCLUSION

For the reasons given above, the decision of the Tax Court should be reversed.

Repectfully submitted,

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NOVEMBER, 1957.

# APPENDIX

| Petitioner's Exhibits | Stipulated |
|---|---|
| The Stonecrest Corporation | |
| 1-A | R. 22 |
| 1-B | R. 22 |
| 3(b) | R. 23 |
| 3(c) | R. 23 |
| 3(d) | R. 23 |
| 3(e) | R. 23 |
| 3(f) | R. 23 |
| 4(a) | R. 23 |
| 5(a) | R. 23 |
| 5(b) | R. 23 |
| 5(c) | R. 24 |
| 6(a) | R. 24 |
| 6(b) | R. 24 |
| 6(c) | R. 24 |
| 6(d) | R. 24 |
| 7(a) | R. 25 |
| 7(b) | R. 25 |
| 7(c) | R. 25 |
| 7(d) | R. 25 |
| 7(e) | R. 25 |
| 7(a-1) | R. 25 |
| 7(a-2) | R. 25 |
| 7(a-3) | R. 25 |
| 8(a) | R. 27 |
| 8(b) | R. 27 |
| 8(c) | R. 27 |
| 9(a) | R. 37 |
| 9(b) | R. 37 |
| 9(c) | R. 38 |
| 9(d) | R. 38 |
| The Brookfield Corporation | |
| 1-A | R. 51 |
| 1-B | R. 52 |

The exhibits attached to the stipulation filed by the Stonecrest Corporation (R. 19-48) and designated as Exhibits 3(b), 3(c), 3(d), 3(e), 3(f), 4(a), 5(a),

5(b), 5(c), 6(a), 6(b), 6(d), 7(a), 7(a-1), 7(a-2), 7(a-3), 7(b), 7(c), 7(d), 7(e), 8(a), 8(b), 8(c), and 9(a), 9(b), 9(c), 9(d) are identical to the corresponding form or agreements used by Brookfield Corporation with the exception that the name Brookfield was substituted for the name Stonecrest on the documents with respect to agreements or business forms used by Brookfield. (R. 54).

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